



Economic Outlook United States 1984

Overview

November 1983

The year 1984 will mark the second year of growth from the four-year stagnation of 1979-82. The economic recovery during 1983 occurred despite fears that large federal budget deficits and high interest rates would prevent a recovery, abort one, or force any recovery to be weak. In fact, not only did the recovery occur, but it turned out to be surprisingly normal. Real Gross National Product (GNP) is expected to grow 6 to 6.5 percent from the end of 1982 to the end of 1983, just about the average of the first four quarters of previous postwar recoveries. The experience of 1983 should help allay the concern that the large federal deficit and still-high interest rates will prevent continued economic expansion in 1984. The extent of that expansion can be seen in Table 1 with real GNP expected to rise 5.6 percent, slightly above average for the second year of postwar recoveries.

However, it cannot be denied that high real interest rates will have a pervasive impact on the economy. They will affect the composition of output, retarding the growth of the interest-sensitive sectors, particularly business investment and housing. And that will eventually reduce the economy's long-run growth path. High rates will also bolster the international value of the dollar, contributing to large deficits in the international trade balances. Moreover, if interest rates were lower, real growth would be stronger. The economy is recovering from an extended period of stagnation. Two back-to-back recessions in the period since 1979 left real GNP at the end of 1982 only one-half percent above its level at the beginning of 1979. As a result, this recovery began with unprecedented amounts of idle resources reflected in a postwar record unemployment rate and record-low capacity utilization rates. Despite good first year growth, the economy will be entering the second year of expansion with still large amounts of idle resources, a high 9 percent unemployment rate, and a relatively low 77 to 78 percent capacity utilization rate.

With an unusually large pool of resources available to be re-employed, and with still large pent-up demands accumulated during four years of no growth, the economy should be able to grow at significantly above-average rates in 1984. Thus, expressions of discontent about the economy's performance should derive not so much from the level of

**TABLE 1 SELECTED ECONOMIC INDICATORS
FOR THE U.S. ECONOMY 1982-1984**

	1982	1983	1984
	(Percent Change)		
Real GNP	-1.9%	3.4%	5.6%
Personal Consumption	1.4	4.4	4.2
Nominal GNP	4.0	7.9	10.8
Consumer Price Index	6.2	3.3	5.3
Consumer Durables	-0.9	11.9	9.0
Plant and Equipment Investment	-4.7	0.3	9.4
Residential Structures Investment	-15.9	40.1	10.9
Exports	-7.8	-5.8	4.2
Imports	1.4	9.8	3.6
	(Volume—Millions of Units)		
New Passenger Car Sales	8.0	9.2	10.4
Total Housing Starts	1.06	1.71	1.73
	(Percent of Work Force)		
Civilian Unemployment Rate	9.7	9.7	8.2

Bank of America estimates for 1983; forecasts for 1984.

growth actually achieved as from the fact that growth could be higher if interest rates were lower.

The Sources of Strength

During the early stages of economic recovery, a few key sectors typically grow quite rapidly and can be characterized as the major forces of economic expansion. As recovery progresses, the stimulus from these sectors diffuses into the rest of the economy and growth becomes more evenly distributed. This will be the case in 1984. Growth will be more broadly based than in 1983, when the major stimulus to expansion was concentrated in consumer expenditures and housing. While no one sector will provide the major stimulus to growth, growth still will not be evenly distributed among major eco-

conomic sectors. Some sectors will expand more rapidly than overall GNP while others will develop more slowly. Those expected to experience above-average growth include residential construction, business expenditures on equipment, and the federal government. Sectors expected to expand more slowly include consumption, state and local governments, net exports, and nonresidential construction.

Consumption—Continued Base for Expansion

Consumer expenditures were a major force in the recovery in 1983 and will continue to be a significant force in 1984. However, with the recovery diffusing among other economic sectors, consumer expenditures will no longer be the major growth force. It is anticipated that total consumer expenditures will grow 4 percent in real terms, somewhat below the 5.6 percent level of GNP.

Growth in consumer spending will be most pronounced in purchases of durables, including such big-ticket items as autos and household furnishings. Purchases of these goods were deferred by consumers during the recession when incomes were growing slowly. As a result, it is anticipated that the spending rate by consumers will increase rapidly through the first half of 1984 as the large backlog of accumulated demand is reduced. However, this trend is not expected to continue throughout the year. During the second half of the year, the growth of consumer spending will begin to slow, primarily because of reduced growth in spending on durable goods. This slowdown results from a reduced backlog of demand, moderate income growth accompanying the slowing economy, and rising interest rates, which raise the cost of debt-financed purchases of durable goods.

Auto sales, which rose steadily through 1983, are expected to rise relatively little in 1984, with sales in the fourth quarter of 1984 little higher than they were at the end of 1983. Viewed on an average annual basis, sales gains appear more impressive. They are expected to rise 13 percent from their 1983 level to average 10.4 million units in 1984.

The near-stagnation in the growth of car sales in 1984 follows a normal pattern: rapid growth early in the cycle followed by a quick flattening in sales. The economic fundamentals contributing to the pattern this time include slowing income growth combined with less favorable price incentives and a smaller backlog of demand than in 1983.

Declining gasoline prices and interest rates along with modest increases in car prices allowed the cost of car ownership to decline in both absolute terms and relative to other prices in 1983. That in turn contributed to stronger sales. During 1984, gasoline prices should rise. The effect, combined with continued increases in car prices, will be to raise the absolute cost of car ownership. However, overall car

costs still are expected to rise less than the overall level of prices, so that the relative cost of car ownership should decline. That drop will be modest: 1 percent compared with 13 percent in 1983. Thus, the price stimulus to further gains in car sales will be more modest in 1984 than in 1983.

A backlog of demand for cars accumulated during the recession. Auto sales averaged 6.2 percent of the driving age population over the period 1961-78. This ratio fell with declining car sales dropping to 4.5 percent by 1982. It is anticipated that this figure will reach 5.8 percent in 1984 with sales of 10.5 million.

If the ratio were to return to its long-run average, sales would reach 11.2 million in 1984 and nearly 12 million in 1985. However, there are reasons to expect the ratio to remain below its long-run average for some time, preventing any quick return to boom sales years. First, while energy prices have weakened since 1981, they are still far above their earlier levels. For example, the average refiner's acquisition price of crude oil in 1984 is anticipated to be twice the level it was in 1978 and 8 times its level in 1972. The associated increase in the cost of operating a car has reduced the total demand for automobile services relative to the population. Second, large increases in the price of autos combined with increased operating life have lengthened the trade-in cycle.

Government Spending To Grow Significantly

The efforts of the Reagan administration to reduce the growth of federal government spending have met with only limited success. Purchases of goods and services, which measure the direct influence of the federal government on aggregate demand, are expected to rise 6 to 7 percent in real terms after a 1.6 percent increase in 1983.

Growth in total real federal spending, which includes transfer payments, slowed slightly in 1983 to 3.3 percent from a 3.7 percent average in the 1970s, but should accelerate to 4 to 4.5 percent in 1984. The increase in total spending conceals a great deal of variation across different categories of spending. Defense purchases will rise 6 to 7 percent in real terms in 1984 while nondefense expenditures will rise a more modest 5 percent. Transfer payments, which include entitlement programs such as Social Security and Medicare, are expected to grow only some 1 percent, a dramatic decline compared with the 8.5 percent annual average growth rate for the period 1966 to 1980.

The major cut in federal spending has come in grants-in-aid to state and local governments. In real terms these have fallen 24 percent since 1978, shrinking their share of the total budget from 17 to 10.5 percent in 1983. However, recent Congressional legislation has reversed this trend for 1984.

Grants-in-aid are expected to rise approximately 4 percent in real terms in 1984.

The most significant squeeze in government spending has come at the state and local government level, where real spending has fallen in each of the past three years. Weakness in this sector reflected revenue losses again caused by the cutback in federal government grants-in-aid and by recession-induced weakness in income growth which reduced the growth of tax revenues. Because most states operate under a balanced budget requirement, these revenue losses forced cutbacks in spending.

State and local government revenues are expected to improve significantly in 1984, reflecting both increases in federal government grants-in-aid and high tax revenues accompanying the stronger economy. This occurrence will allow state and local government spending to increase some 2 percent in 1984.

Housing To Expand but at Slower Rate

The housing sector began its recovery in 1982, a full year ahead of the economy-wide turnaround, and was a major force in 1983's recovery. High interest rates will prevent much additional expansion in 1984. Housing starts should average 1.70 to 1.75 million units over the year, little changed from the 1983 average.

It is typical for a housing recovery to taper off as an economic expansion continues. This recovery is unusual in that housing starts are at a level considerably below their peaks of the 1970s, despite the fact that the economic fundamentals point to a higher level. The shortfall reflects the effect that high interest rates and high prices are having on housing affordability. Approximately 25 to 30 percent of households can now afford the costs of ownership of a median-priced house. While that is up from the 20 to 25 percent range in 1982, it remains well below the 44 percent average of the 1973 to 1980 period. As mortgage interest rates edge up in 1984, their restraining effect will rise. But affordability reflects mortgage payments relative to income. Mortgage payments will rise, but so will incomes. The net effect is expected to be a slowly rising level of housing starts through the year.

The primary determinants of long-run demand for housing—population and income trends—will have a positive effect in 1984. The total adult population should increase 2.7 million in 1984. It is anticipated that the population aged 25-44, which forms the prime first-time home-buying group, will grow more rapidly than the population as a whole as the members of the baby boom age.

Income growth will strengthen, providing additional support to housing demand. Real disposable income should grow 4.5 percent in 1984, compared

with 3.1 percent in 1983. Moreover, consumers increased their liquidity during the recession, increasing their financial assets and reducing their debt. Consequently, they are in a good position to incur additional mortgage debt without straining their capacity to pay that debt.

Business Investment Looks Good; Equipment Purchases Expected To Grow

The outlook for business fixed investment in 1984 is the most favorable of the last five years. The incentives to business investment contained in the Economic Recovery and Tax Act of 1981 (ERTA) helped to reduce the decline in investment during the recession. With sales now growing, these incentives are expected to help raise real business investment 9 to 10 percent in 1984.

While high real interest rates could retard the growth of investment, their negative effect should be partly offset by the accelerated depreciation allowances and investment tax credits provided in ERTA. For example, to achieve a 4 percent real after-tax return on equity-financed industrial equipment required a 6.2 percent before-tax return in the late 1970s. But in 1984, that 4 percent after-tax return can be achieved with only a 3 percent before-tax return. The impact is less dramatic for investment in structures, with the real before-tax rate required for a 4 percent after-tax return dropping from 9 percent in the late 1970s to 6 percent in 1984.

Growth in business investment during 1984 is expected to be concentrated in spending on equipment, which should rise 12 to 13 percent compared with a modest 3 percent growth in spending on structures. As a result, equipment's share in total investment should rise above its historical average of 66 percent to over 70 percent in 1984.

Businesses have made significant progress in restructuring and improving the deteriorated balance sheets that were a drag on investment in 1983. Improved internal cash flow, the improved equity market, and the availability of lower-cost long-term debt have allowed businesses to reliquify, reducing their total debt and lengthening its maturity. Since this action reduces the implicit cost of funds, it provides an additional stimulus to investment.

Value of Dollar May Decline; U.S. Exports Could Increase

The foreign trade sector is expected to continue as a drag on the economy in 1984 causing further deterioration in major international trade accounts. Net exports are expected to decline \$6 billion to \$8 billion. The merchandise trade deficit in 1984 should rise \$10 billion to \$80 billion. The deficit on current

account is expected to grow to \$40 billion in 1984, up \$5 billion from 1983.

The economic deterioration of the foreign trade sector, which continues the trend begun in 1983, reflects the effects of the high international value of the dollar, lagging recoveries in other countries and the international debt crisis.

The dollar declined throughout the 1970s, and by 1980 had fallen to only 70 percent of its 1969 value. But in the short period since President Reagan's election it has risen 50 percent, totally reversing a decade's decline and carrying the dollar to new highs. The dollar's strength largely reflects a capital inflow induced partly by high real interest rates and partly by the continued perception among foreign investors of the United States as an island of political and economic stability in a world of increasing risk.

The high value of the dollar has raised the prices of U.S. exports and reduced the prices of imported goods. These price changes have retarded foreign demand for U.S. exports and increased domestic demand for imported goods.

The dollar is now about 20 percent above the level suggested by economic fundamentals—such as relative inflation rates—and so should decline. The rising trade deficit is putting downward pressure on the dollar. But as long as interest rates and risk assessments create large capital inflows, the decline is likely to be slow. It is anticipated that the dollar will depreciate 10 percent in 1984. That will lower the prices of export goods and raise the prices of import goods. But because quantities demanded respond to changing prices with a one-to-two year lag, the depreciating dollar will have little beneficial impact on U.S. exports and imports in 1984.

The unsynchronized recovery of the world's economies is contributing to divergent movements in U.S. exports and imports. With the United States again leading the rest of the world out of the global recession, the economies of many of our major trading partners are lagging. As a result while rising U.S. incomes are stimulating our demand for imported goods, the slower growing incomes in other countries are not providing an equal stimulus to our exports.

Finally, while the international debt crisis no longer appears prominently in the press, its effects have not disappeared. Many countries incurred large debts in the 1970s, expecting to repay them with export earnings. But the worldwide recession, adverse movements in the terms of trade, and slower inflation sharply curtailed the export growth of those countries. At the same time, high interest rates contributed to a high debt servicing burden. As a result, many countries, including Mexico, Brazil, Argentina, and Venezuela, are having trouble servicing their debts.

In an effort to raise their exports and reduce their imports, many of these countries have instituted import restrictions and austere domestic fiscal and

monetary policies that have reduced growth of their domestic economies and with it their demands for imported goods. The result is a shrinkage in U.S. export markets.

As a result of these factors—the high value of the dollar, lagging foreign economies, and foreign debt service problems—U.S. exports are expected to grow during 1984, but by a smaller amount than imports. In real terms, exports should rise 4 percent to 6 percent, while imports should grow 8 percent to 10 percent.

Inflation—Still Moderate in 1984

The most stunning economic accomplishment during the Reagan administration was the success in reducing inflation. The rate of increase in the Consumer Price Index plummeted from 13.3 percent in 1979 to 3.3 percent in 1983. Even as measured by the GNP price deflator, a far broader and more stable measure of prices, inflation was reduced by one-half, dropping from a peak of 9.2 percent in 1980 to approximately 4.3 percent in 1983.

While it is possible to point to individual prices as leading the decline in inflation, the root cause was the reduction in money growth engineered by the Federal Reserve. Its policy of stringent growth in the stock of money led to weak product and labor demands and slower rates of price and wage increases. Declines in actual wage and price inflation contributed to lowered expectations of future wage and price inflation. Creating a new set of inflation expectations was the key to breaking the wage-price spiral. Businessmen and labor leaders had seen restrictive policies adopted many times before in the 1980s and 1970s. Each time, restraint proved temporary and was followed by stimulative and inflationary policies. So long as businesses expected new stimulus and inflation, they resisted the pressure to moderate their own prices, cutting output instead. But as they came to believe that restraint was real and permanent, they changed their expectations of inflation and moderated their own price behavior.

The consensus now seems to be that inflation will remain moderate—near its 1983 level—in 1984 and beyond. Unfortunately, that expectation may prove to be overly optimistic, for it is possible that recent excessive monetary stimulus will begin to appear in higher inflation by 1985 and possibly as soon as mid-1984.

There are two ways to forecast inflation. One is to examine the immediate determinants of prices—unit costs. The other is to look at the ultimate determinant of prices—the growth of the money stock. These approaches currently yield conflicting inflation forecasts.

Over time, the growth of prices tends to parallel the growth of unit costs. Unit labor costs, accounting

for two-thirds of total costs, are determined by the growth of wages and productivity. The downward pressure on wages exerted by the high unemployment rates of the past several years will moderate as the unemployment rate declines in 1984. As the wage concessions and give-backs that appeared in highly distressed industries disappear, the rate of wage increase will accelerate. However, despite a declining rate of unemployment, joblessness still will be in the 7.5 to 8.0 percent range at the end of 1984. That rate should be high enough to prevent any significant acceleration in the rate of wage increase. Moreover, the inflation improvement of the past several years will still be feeding into wage settlements both directly through cost of living allowances and indirectly through reduced inflation expectations. The net effect should be a rate of wage increase of 4.8 to 5 percent, up only slightly from 1983's 4.5 to 4.7 percent increase.

Productivity growth went through its early expansion surge in 1983, rising 3.2 percent. It is expected to grow at a somewhat slower rate—2.5 to 3 percent—in 1984. The net result should be growth in unit labor costs of approximately 3 to 3.5 percent, up only modestly from 1983's 2.4 percent increase. That increase was consistent with a 1983 increase in the GNP price deflator of 4.3 percent. An increase in the growth of unit labor cost of 0.5 to 1 percent in 1984 would imply an increase in overall inflation of the same amount. That implies an increase in the GNP price deflator of from 4.3 percent in 1983 to approximately 4.8 to 5.3 percent in 1984.

The Consumer Price Index is more volatile than the GNP price deflator, largely because it measures a narrower variety of goods and services. For example, while the CPI rose to a peak of 13.3 percent in 1979 and subsequently fell to slightly over 3 percent in 1983, the GNP price deflator peaked at 9.2 percent and fell to 4.3 percent for 1983.

In 1984, consumer prices will rise somewhat more rapidly than the overall price level, in part because the moderating influence of declining energy prices and slowly rising food prices will disappear. Energy prices fell over the 1982-83 period as the worldwide recession and continuing conservation efforts reduced energy demand. During 1984, worldwide economic recovery will bring energy demands into closer alignment with supply, leading to mild increases in energy prices in 1984. The severe drought and heat wave in 1983 drove up grain prices. The higher cost of feeding livestock and poultry will cause a cutback in supplies and higher prices of meat in 1984. The rate of increase in the food and beverage component of the CPI will rise 6 to 7 percent in 1984, compared with an increase of only 2.4 percent in 1983. Nevertheless, while consumer prices will rise more than the overall level of prices, both measures will be close. The CPI will rise 0.2 to 0.4 percentage points more than the deflator.

Therefore, a structural analysis of the immediate determinants of inflation suggests little danger of a major rise in 1984. At worst, inflation will show a modest uptrend as markets firm with the expansion.

The alternative approach to forecasting inflation has more ominous implications. A good rule of thumb for forecasting inflation in any year is the average rate of money growth in the previous three years. The rate of growth of the narrowly defined money stock, M1, has risen from 5.1 percent in 1981 to 8.5 percent in 1982 and 10.8 percent in 1983. The massive expansion of M1 in 1983 contributed to rapid nominal GNP growth and raised the three-year money growth average to 8.1 percent, which implies an equal rate of inflation. Normally, a change in money expansion initially affects the growth of real output. After a lag of one or two years, inflation subsequently changes. Since money growth began to accelerate in mid-1982, inflation could begin to accelerate any time, but most likely, it will begin rising near mid-1984.

It is doubtful that inflation will surge to over 8 percent as implied by the simple money rule of thumb. Unless real growth in the economy surges more than expected, which is a possibility, there should still be enough slack in the economy, as suggested by the structural analysis, to moderate the inflationary pressure from money. Moreover, the historical relationship between money and GNP appears to have weakened during 1983. Unless that relationship returns to normal, which is also possible, money growth will have less of an inflationary stimulus than normal. Finally, if the Federal Reserve manages to reduce money growth in late 1983 and 1984, it will begin to offset or contain the inflationary pressures.

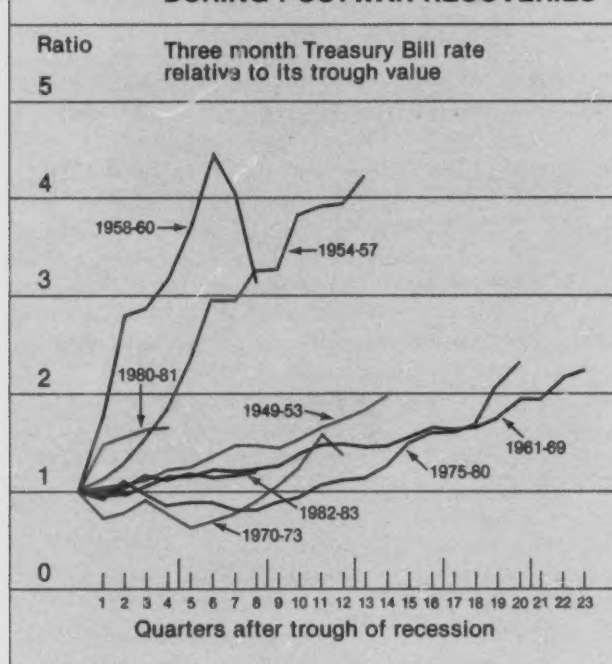
Even with all these caveats, the fact remains that recent rapid money growth creates an upside risk to inflation in 1984, particularly in the second half of the year. As measured by the GNP price deflator, inflation is likely to average 5 percent in 1984, with quarterly inflation rates in the same range. However, there is a risk that it could be higher, with quarterly rates reaching the 7 to 8 percent range in the second half of the year.

Short-Term Interest Rates Should Increase Slightly

In trying to forecast the likely path of interest rates, a simple but powerful fact to remember is that interest rates rise during recoveries. Chart 1 shows that interest rates have trended up in the recovery phase of each of the seven postwar cycles—immediately following the trough in four of the cases, and after lags of two to eight quarters in the others. During the present recovery, the increase in rates has almost exactly paralleled the rise of the 1949-53 recovery.

The forces that usually lead to rising rates are expected to be present in 1984. Real private credit demands began to rise in the first quarter of 1983

**CHART 1 INTEREST RATE MOVEMENTS
DURING POSTWAR RECOVERIES**



and are likely to continue increasing in 1984. Rising inflation will add to the growth of nominal credit demands.

The federal deficit adds an additional factor this time. The deficit usually grows during economic downturns as declining incomes reduce tax revenues. The deficit usually shrinks during the subsequent recovery as the progressive income tax causes tax revenues to grow more rapidly than expenditures.

This can be seen in Table 2 which shows deficits over the past decade as percentages of GNP and net new funds raised by final users of credit. In 1976, the deficit rose to a then record high of 4.5 percent of GNP. That was a recession year when tax revenues declined and government transfer payments rose. The percentage declined from 1976 to 1979 as tax revenues rose with the recovery. The percentage increased again in 1980 when the long double-dip recession began, and it worsened in 1982 as the recession hit bottom.

Typically, one would expect the deficit to shrink as a percentage of GNP during an economic expansion. However, the tax changes instituted by the Reagan administration have diminished the progressivity of the tax structure. Consequently, the deficit rose to 6.5 percent of GNP in 1983 and should remain at 5 to 6 percent in 1984.

The same pattern can be seen in the deficit as a percentage of total net new borrowings by final users in the nation's credit markets. These include the federal and state and local governments, house-

holds, businesses, and foreigners. In 1983 and 1984, the federal government will take a record share—about 40 percent of all net new borrowings as can be seen in Table 2.

The combination of rising private credit demands, rising inflation, and a large federal deficit will lead to a modest uptrend in rates. Short rates are expected to rise 50 basis points between the end of 1983 and the end of 1984.

Money and Fiscal Policies Remain Keys To Future Health

There have been periods in United States economic history when economic policy held to an even keel, creating few disruptions for the economy and holding few surprises for forecasters. However, that has not been the case for the U.S. in the last several years. Since 1979, two major changes of policy have pushed the economy in widely different directions. The first began in 1979 when the Federal Reserve started to slow the growth of the money stock in an effort to reduce inflation. It continued with the efforts of the Reagan administration to institute a conservative fiscal policy.

Both developments represented a marked shift from the policy stance of the preceding decade and a half. Policy during that period was on average aggressively expansive and inflationary. Efforts at restraint were intermittent and spasmodic as policy-makers proved unable to adhere to programs of restraint for more than short periods. As a result, the best assumption an individual looking ahead five years or so could make was that inflation and interest rates would be higher at the end of the period than at the beginning. And since rising inflation would eventually bring a policy reaction to reduce it, there would probably also be a least one policy-created downturn over that interval.

The key question at the time of the 1979-80 shift to restraint was whether it could prove durable enough to permanently alter basic economic trends and so institute a new set of expectations—not just about inflation but about the basic role of government in the economy, the regulatory environment, and taxes. The answer depended on the willingness of the electorate to bear the costs of restraint and on whether the policies could be instituted skillfully enough to keep the costs within the public's threshold of tolerance.

Unfortunately, the question still remains, for the way in which policy was implemented led to a second policy shift. Monetary policy tightened too much too quickly, creating a postwar record unemployment rate, rising domestic bankruptcies, and the threat of international financial collapse. The monetary authorities reacted in mid-1982 by switching to a policy of aggressive ease. After reducing the growth

of M1 to 5.1 percent in 1981 from a previous 5 year average of 7.4 percent, the Federal Reserve allowed M1 expansion to rocket to 10.8 percent in 1983. That is higher even than the growth rates of the high-inflation years of the 1970s. That rate of money growth was not as stimulative as the simple number would suggest, for institutional changes, such as the introduction of money market deposit accounts, distorted the meaning of M1. But even after allowing for these changes, monetary policy was aggressively stimulative.

TABLE 2 RELATIVE SIZE OF U.S. FEDERAL DEFICITS

Two Perspectives			
(A) Fiscal Year	(B) Federal Government Deficit ¹ (billions of dollars)	(C) As a Percentage of GNP	(D) As a Percentage of Total Net New Funds Raised by Final Users ²
1973	14.9	1.2%	7.9%
1974	6.1	0.4%	3.5%
1975	53.2	3.6%	31.9%
1976	73.7	4.5%	31.9%
1977	53.6	2.9%	18.3%
1978	59.2	2.8%	16.1%
1979	40.2	1.7%	10.4%
1980	73.8	2.9%	21.8%
1981	78.9	2.8%	20.7%
1982	128.0	4.2%	33.5%
1983*	210.0	6.5%	43.9%
1984*	200.0	5.6%	38.0%

* Bank of America forecasts.
¹ The sum of the unified budget deficit and the off-budget deficit.
² Excluding equities.

The crucial question is whether this second policy shift is permanent or temporary. On the one hand, it may signal a permanent reversion to old policies of excessive money growth and a resumption of the trend of rising inflation. Alternatively, it may prove to be only an interlude, with money growth eventually returning to a path that will gradually slow inflation. But even in the latter event, the recent episode of monetary stimulus means that the era of disinflation is over for the near term, to be followed by at least a cyclical upswing in inflation.

If the Federal Reserve does not slow money growth, inflation will begin to rise dramatically within the next year. If the Federal Reserve tries to slow money growth enough to prevent any increase at all in inflation, or if it tries to obtain further declines in inflation in 1984, the degree of monetary restraint would be so severe as to force significant

increases in interest rates and a probable downturn in the economy. In an election year that would bring a political eruption possibly severe enough to threaten the autonomy of the Federal Reserve. Caught between these unpleasant alternatives, the Federal Reserve will in all likelihood choose the middle course, reducing money growth from the rapid rates of 1982-83 but holding it above the restrictive level of the period from 1980 to mid-1982.

It is possible that the monetary authorities have already caught themselves in a policy bind. The basic problem is that changes in the rate of monetary growth affect the economy with a lag of from six months to a year. As a result, the effects of current policy are not observable in real growth or inflation until some time in the future.

The rapid money growth that began in mid-1982 created a very substantial stimulus that has not finished working its way through the economy. It is possible that this stimulus will be greater than generally expected and create a more vigorous recovery and stronger inflation pressures. Alternatively, it is possible that the Fed, in an effort to avoid stifling economic expansion, will reduce money growth slowly. If so, policy will remain stimulative. In either case the result could be rapid real growth and accelerating inflation during the second half of 1984.

If the Fed acts as it has in the past, it finally will react to the evidence of over-heating by over-reacting. Policy would be tightened too much and throw the economy into a recession. That result might occur even if the Fed begins to tighten now. Because of the lag in the effect of policy on the macro-economy, tightening will have no immediately perceptible effect. If the Fed acts with its historical short-sightedness, it will tighten even more. When the restraint finally manifests itself, it will be in the form of a recession.

Fiscal policy will remain expansive, throwing the burden of restraining inflation on monetary policy and increasing the difficulty of maintaining a moderate monetary policy. The Reagan administration began its effort to reduce the growth of government spending with tax cuts in the hope that the threat of large deficits would induce Congress to create matching cuts in spending. But conflicting budget goals and self-imposed constraints virtually doomed that strategy from the start. The administration wanted to cut the growth of total spending while increasing the growth of defense spending. At the same time, for political reasons, it put the major entitlement programs (particularly Social Security) largely off-limits to cuts. These constraints left less than 20 percent of the budget to bear the brunt of the spending cuts.

Enough success was achieved to reduce the growth of real federal spending to 3.3 percent in 1983, but the process of constraining spending growth is now stalled if not ended. The administra-

tion remains committed to a major defense buildup, Congress shows no willingness to seriously constrain growth in entitlements, interest on the public debt will continue to grow rapidly, and the rest of the budget will prove increasingly difficult to cut as each additional reduction reaches closer to the heart of each program.

As a result, real federal expenditures are expected to grow 4 percent in 1984, little changed from the rates of 1981-82. For the period 1981-85, real federal spending growth should average 3.9 percent. While that is down from the 4.5 percent rate of the 1960s, it is little different from the 3.7 percent rate of the 1971-80 period. Equally important, it remains above the growth rate of the overall economy. As a result, and ironically in view of the administration's goals, federal spending as a share of GNP should rise from 23.4 percent in 1981 to nearly 25 percent in 1984.

The large federal deficits looming in 1984 and beyond are the direct result of this rapid spending growth. It is simply not correct to attribute these deficits to the tax cuts begun in 1981. It is certainly true that if there had been no tax changes in 1981, tax revenues would now be higher and the deficit would be lower. But it is also true that on balance there has been no tax reduction. The "tax cuts" of the past three years have simply offset increases from higher Social Security taxes and inflation-induced bracket creep. The effective tax burden remains unchanged. Unless one wants to assert that the ratio of taxes to income and the government's share of output should always rise, the deficits can more properly be attributed to continued rapid growth in government spending.

One way to separate the role of taxes and spending in the deficit is by examining changes in the "high-employment deficit." This measure abstracts from cyclical influences on the deficit by estimating what the levels of government expenditures and revenues would be if the economy were operating at full employment of labor and capital. In 1984, it is anticipated that the high-employment budget deficit will rise \$34 billion, following an increase of \$49 billion in 1983. Tax cuts should reduce revenues by \$27 billion. But the increase in taxes due to inflation, plus the increase in Social Security taxes, will raise taxes nearly \$26 billion, leaving a net tax cut of \$1 billion. At the same time, "high-employment" federal expenditures are expected to rise \$13 billion.

The deficits are expected to absorb approximately 40 percent of total domestic nonfinancial borrowing, twice the average of the preceding 10 years, and so will make interest rates higher than they otherwise would be. That increases the Federal Reserve's problems in reducing money growth since it will be under pressure to reduce rates by buying some of the government debt. But to do so means reducing its control of the money stock.

The long-run significance of the fiscal-monetary policy mix lies in its effect on the composition of national output and longer-run growth prospects. The Reagan administration's original intent was to raise productivity growth through tax cuts aimed at increasing savings and investment and by reducing government interference in the economy. While the tax cuts are still largely in place, their stimulative effect on investment is likely to be reduced or even overpowered by the crowding out of interest-sensitive expenditures by the federal deficit.

This is not a trivial concern. The government deficit and net private investment are financed from net private domestic savings. During the 1970s the government deficit absorbed about one-fifth of net savings, leaving four-fifths for net private investment. But in the early 1980s the deficit absorbed over two-thirds, leaving only one-third for net private investment. And the share absorbed by the deficit over the next few years is expected to remain well above the average level of the 1970s.

As a result, the business investment share of GNP will approximate only 10 to 10.5 percent in 1984 and 1985, well below its 11.8 percent level in 1981 and no stronger than its 10.5 percent average of the 1970s. That is unfortunate, for the economy will need the stimulus to productivity and growth that greater investment would provide. The rate of growth of the labor force probably will fall from an average of 1.6 percent per year during the 1970s to near 1 percent by the end of this decade. Unless offset by increased productivity growth, that will cut an equal amount from the aggregate growth rate. Productivity growth will rise, partly because slower labor force growth means that each worker will have more capital to work with and partly because the average age and skill level of the labor force will rise. But it will not rise by enough to fully offset the negative effect or real growth of the slowing labor force. To do that will require significantly stronger investment.

Bank of America NT&SA, founded in 1904 by A. P. Giannini, has some 1,077 branches in California communities and 135 branches and representative offices overseas. As of September 30, 1983, BankAmerica Corporation's consolidated assets were more than \$122 billion.

Prepared by the Economics-Policy Research Department of Bank of America using data available as of 11/5/83. Additional copies of this report may be obtained by writing to Corporate Communications Planning and Administration #3401, Bank of America, Box 37000, San Francisco, CA 94137.

 **Bank of America**